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Use Arbitration to Protect Non-Competes

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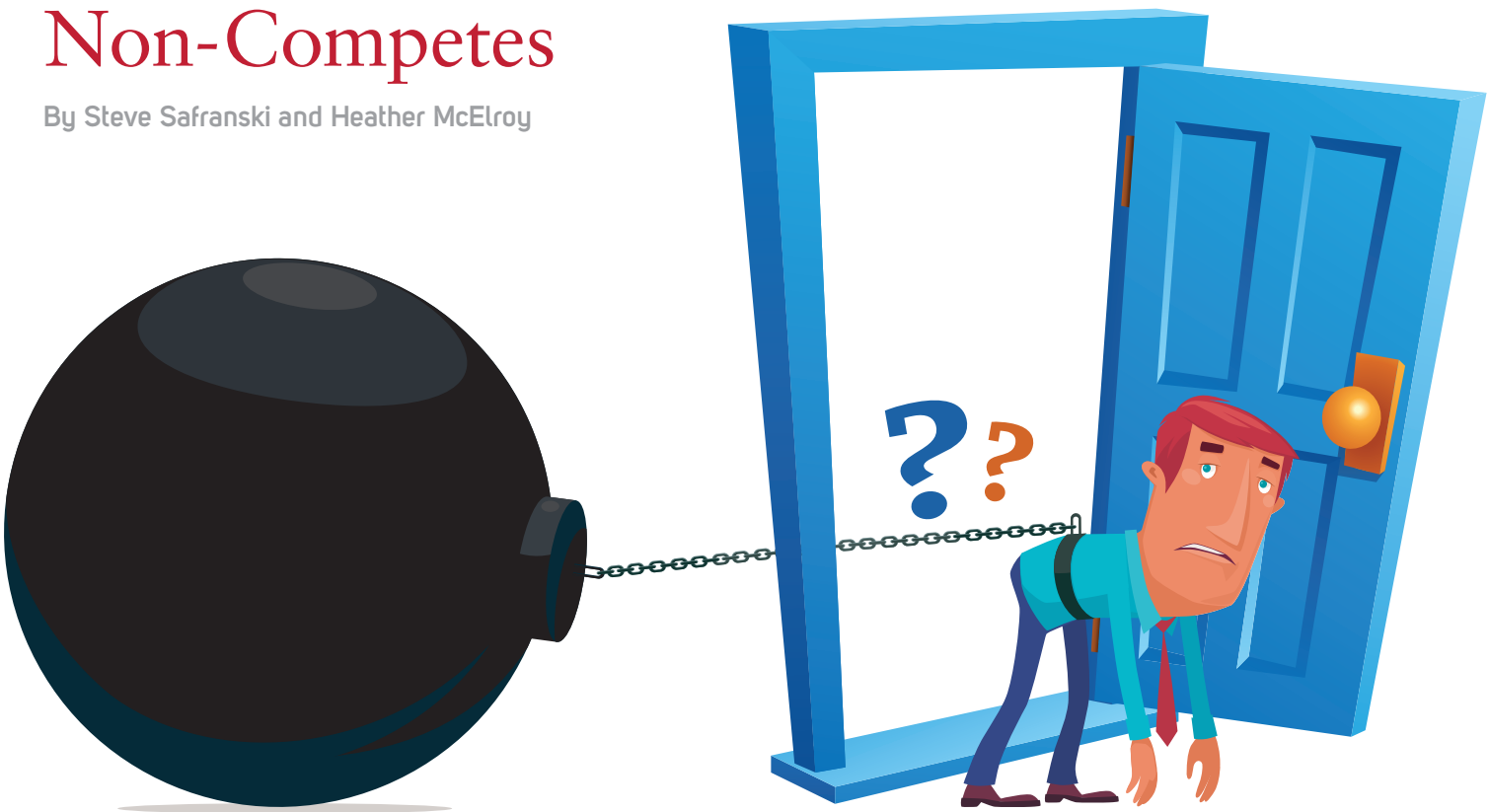

It's a familiar story: an employee bound by a non-competition covenant is recruited by a competitor in a jurisdiction that refuses to enforce the covenant, and a race to the courthouse ensues. The employee files a declaratory-judgment action in the unfriendly jurisdiction to invalidate the non-compete, and the former employer files a competing enforcement action in its home state. With two parallel lawsuits, the results are far from ideal. At best, it's a costly jurisdictional fight with competing motions in different courts. At worst, the non-compete is invalidated.

Traditionally, employers have used choice-of-law or forum-selection clauses to try to secure a favorable venue in which to litigate the validity and scope of a non-competition provision and avoid unfriendly state law. But in certain jurisdictions, these clauses have not been effective. The United States Supreme Court's recent decision in *Nitro-Lift Technologies LLC v. Howard* suggests a solution: a properly drafted arbitration provision in the employment agreement would allow for efficient, low-cost enforcement, and offer multi-state employers greater confidence in the enforceability of their agreements.

DECLARATORY JUDGMENT ATTACK

Multi-state employers seeking to protect their goodwill and confidential information with non-compete provisions have faced a longstanding conundrum due to inconsistent state laws regarding enforcement. Most problematic, however, are jurisdictions, like North Dakota, Montana, Oklahoma, and California, with a stated "fundamental public policy" against non-competes.

California has become the finish line for many races to the courthouse to challenge post-employment covenants, because California courts almost universally refuse to enforce such provisions. Section 16600 of California's Business and Professions Code outright prohibits non-competes: "Every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any

kind, is to that extent void."

For years, California courts have used Section 16600 to invalidate agreements that restrain an employee from engaging in competitive employment after leaving a former employer, no matter where the former employer resides or where the non-competition agreement was signed.

In *Application Group, Inc. v. Hunter*, decided in 1998, the California Court of Appeals expanded Section 16600 into a statute of national scope. AGI, a California employer, recruited one of Hunter's Maryland employees who had signed a non-compete in Maryland and promptly filed a declaratory-relief action in California to void the non-compete. Affirming the trial court, the First District invalidated the non-compete even though the former employee still worked for AGI in Maryland and never intended to move to California, reasoning that Section 16600 was intended to ensure that "California employers will be able to compete effectively for the most talented, skilled employees in their industries, wherever they reside."

This decision paved the way for an onslaught of lawsuits by California employers to invalidate restrictive employment covenants. One of the favored tactics of former employees and their California employers has been to file a declaratory-judgment action to void the non-competition covenant, often before the former employer can even get an action filed in its home state. These preemptive declaratory-judgment suits are often successful.

Employers have attempted to save their non-competes by inserting choice-of-law provisions into their employment agreements. This has not always been effective, as they can be trumped by a fundamental policy against post-employment restrictive covenants. For example, California courts will typically not enforce choice-of-law provisions in non-compete cases on the grounds that any state's law that would uphold the provision is considered antithetical to California's strong public policy against them.

A specific forum-selection clause may fare better, but again, it is not a sure bet. For example, in *Bunker Hill International, Ltd. v. Nationsbuilder Insurance Services* (2011), the Georgia Court of Appeals reversed the enforcement of a forum selection clause in a non-compete agreement, holding that it "is void because its application would likely result in the enforcement by an Illinois court of at least one covenant in violation of Georgia public policy."

This means that, in the context of litigating non-competition covenants, races to the courthouse continue. These cases have inconsistent results, and nearly always involve protracted litigation and expensive motion practice.

Advanced Bionics Corp. v. Medtronic, Inc. provides a prime example of a prolonged jurisdictional fight over a non-competition covenant. When a Medtronic employee with a two-year post-employment non-compete was recruited by California company Advanced Bionics, both the Minnesota and California state courts asserted jurisdiction and enjoined proceedings in the other court. Even though the employment agreement selected Minnesota law, the California Court of Appeals (2001) held that California law would apply and enjoined the Minnesota case.

Meanwhile, the Minnesota courts enforced the non-compete and upheld the Minnesota courts' exercise of jurisdiction. Ultimately, the California Supreme Court (2002) reversed the order enjoining Medtronic from proceeding in Minnesota, but the action to invalidate the non-compete could still proceed simultaneously in California. The end result? Two parallel proceedings were permitted to continue in tandem, in a "race to judgment."

The United States Supreme Court's Nitro-Lift decision suggests a solution to the litigation marathon. The dispute in Nitro-Lift arose from a contract between employer Nitro-Lift Technologies LLC and two of its former employees who had entered into confidentiality and non-competition covenants. The contract also contained an arbitration clause, which provided that any dispute between Nitro-Lift and the employee "shall be settled by arbitration ... in an arbitration proceeding conducted in Houston, Texas..."

After the two Nitro-Lift employees left for a competitor, Nitro-Lift instituted an arbitration action alleging breach of the non-competes. The employees turned around and filed suit in Oklahoma state court (a state that prohibits non-competes), asking the court to void the non-competition agreements. After several appeals, the Oklahoma Supreme Court agreed and declared the non-competition clauses "void and unenforceable as against Oklahoma's public policy."

On further appeal to the U.S. Supreme Court, the high court vacated the Oklahoma Supreme Court's decision, concluding that it had disregarded Supreme Court precedent on the Federal Arbitration Act when it declared the non-competition covenants null and void. The FAA "declares a national policy favoring arbitration," and provides that a written arbitration clause in a contract "is valid, irrevocable, and enforceable." And, it says, when parties commit to arbitrate contractual disputes, "attacks on the validity of the contract ... are to be resolved by the arbitrator in the first instance, not by a federal or state court."

According to Nitro-Lift, public policy, no matter how significant, will not prevent enforcement of an arbitration clause. While in some jurisdictions "fundamental public policy" may trump choice-of-law and forum selection clauses, they cannot trump arbitration under the FAA.

THE ARBITRATION CLAUSE

So what does such an effective arbitration clause look like? First, it must be mandatory.

Second, it should contain a choice-of-law provision, and an exclusive forum-selection clause providing that the arbitration take place in a particular state, with that state's law

to apply. To ensure enforceability, the designated forum should have a significant connection to the underlying employment relationship.

Third, the arbitration clause should explicitly state that the arbitrator has authority to grant injunctive and provisional relief in order to enforce the terms of the agreement, i.e., "Upon application of any Party, the arbitrator may require specific performance of any provision of this Agreement, including the award of emergency, temporary, or preliminary injunctive relief."

Fourth, to address the need for speed, the parties should agree that the arbitrator apply the AAA Optional Rules for Emergency Measures of Protection, which provide a protocol for seeking immediate, emergency relief. To avoid later challenges to the arbitration clause based on procedural unconscionability, attach a copy of these rules (and any other arbitration rules to be invoked) to the employment agreement.

Fifth, to deter a race to the courthouse to challenge the arbitration agreement, the parties may include a provision providing for attorney fees in enforcing the arbitration clause. But do not overreach. Make the obligations reciprocal.

Lastly, draft the arbitration clause, as well as the rest of the employment agreement, in clear, simple terms, flagged with individual headings. Do not bury it in a lengthy, single-spaced 20-page contract. Consider asking the employee to initial the arbitration provision separately to ensure that he or she consented to its terms.

An effective arbitration clause, although a welcome alternative to a costly jurisdictional courtroom battle, will not guarantee enforcement of the non-competition covenants. To be enforceable, the non-compete must still meet the substantive requirements of the chosen jurisdiction. All told, however, a carefully drafted arbitration clause with defensible choice-of-law and venue provisions and a protocol for seeking emergency relief will undoubtedly provide a more efficient and lower-cost alternative to the race to the courthouse. ■

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